

2/21/02

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF INDIANA
INDIANAPOLIS DIVISION

JAMES A. KNAUER as the Court Appointed)
Receiver for HEARTLAND)
FINANCIAL SERVICES, INC., and JMS)
INVESTMENT GROUP, LLC,)

Plaintiff,)

v.) CAUSE NO.: IP 01-1168-C-K/T

JONATHON ROBERTS FINANCIAL)
GROUP, INC.,)
ALLIANCE CAPITAL MANAGEMENT)
CORP.,)
ANDOVER SECURITIES INC.,)
FSC SECURITIES CORPORATION, and)
FFP SECURITIES, INC.,)

Defendants.)

FSC SECURITIES CORPORATION
REPLY BRIEF IN SUPPORT OF MOTION TO DISMISS

On October 9, 2001, FSC Securities Corporation moved to dismiss the Plaintiff's Complaint pursuant to Rule FRCP 12(b)(1) and 12(b)(6) because 1. As Receiver, the Plaintiff lacked standing to pursue the claims; 2. The court order controlling the receivership did not give the Receiver the authority to pursue the claims; 3. As a matter of law, the Plaintiff is in pari delicto and thus, is barred from pursuing these claims; 4. All of the Plaintiff's claims were barred by the statute of limitations; 5. All claims of JMS Investment Group, LLC must be dismissed because it did not exist during the time when FSC Securities Corporation had any affiliation with the two individuals from whom the Plaintiff argues FSC's liability has sprung;. FSC Securities Corporation also joined in the motions to dismiss filed by its Co-Defendants for those reasons set

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forth in Co-Defendants' independent Motion to Dismiss. The Plaintiff filed a response alleging that the receiver does not stand in the shoes of the corporation in receivership and that it is not liable for the actions of its top management.

**I. THE PLAINTIFF HAS CONCEDED THAT
JMS INVESTMENT GROUP, LLC.'S CLAIMS
AGAINST FSC SECURITIES CORPORATION MUST BE DISMISSED**

In its response to FSC Securities Corporation's Motion to Dismiss, the Plaintiff has failed to respond in any way to the argument that the claims of JMS Investment Group, LLC, by and through the Receiver, must be dismissed. The facts of the Complaint show that JMS Investment Group, LLC did not exist during all of the time periods which the Plaintiff's Complaint alleges that FSC Securities Corporation had any relationship with Kenneth Payne or Gary Danker.

Thus, regardless of the disposition of the other issues before the court, an order must be entered dismissing any claims that the Receiver asserts on behalf of JMS Investment Group, LLC against FSC Securities Corporation.

**II. THE CORPORATIONS WHICH ENGAGED IN AND
PERPETRATED THE FRAUD WERE NOT DAMAGED**

Plaintiff has executed a surprising reversal from the theory presented in complaint to the one presented in the response to the Motion to Dismiss. The complaint has spent almost its entire verbiage dealing with fraud on the investors, damage to the investors, reliance by the investors, and sales of securities to the investors, however, Plaintiff's response brief now takes the position that all of this verbiage was apparently completely unnecessary. Apparently, the only matter currently being sought by the Receiver is an alleged theft of money from Heartland and JMS by its own officers and some alleged fraud on Heartland and JMS, although no such

fraud has ever been mentioned in the Receiver's actual complaint. In order to get where it seeks to go, Plaintiff asks this court to turn the established tenets of the law of receivership, principal and agent, equity, and corporate responsibility on their respective heads.

The Receiver argues that the loss of the funds that were supposed to be on deposit constitutes the alleged damage to the corporations. This theory is regularly dismissed. Plaintiff's argument is simply a perpetuation of the Ponzi scheme. Instead of asking investors to believe that the money originally was going to be put to some good use or that it was rightfully held by Heartland or JMS and then "looted," the Receiver now wants the Court to buy into the scheme. The money was stolen from the investors by the corporations in receivership (according to the Complaint) and was never rightfully held.

A. A THIEF IS NOT DAMAGED WHEN THE ITEMS
THAT THE THIEF STOLE ARE KNOWINGLY
TRANSFERRED TO OTHER THIEVES.

The concept that Heartland has been damaged when its principals took the money that Heartland stole and used it for illicit means is simply put, ludicrous. Heartland has no more claim for damages than does a burglar who has handed the television out the window to his double-crossing accomplice who in turn absconds with the loot. The reason for this remedy disallowance is axiomatic. Heartland and JMS were perpetrators of the fraudulent scheme; they were even beneficiaries of the fraudulent scheme; but they were not victims of the fraudulent scheme. Heartland and JMS had millions of dollars to pay salaries and other such expenses based on a fraud that was knowingly perpetrated by the corporation and its top management as alleged in the Complaint.

An illustrative case citing various federal authorities is worth noting in Johnson v. Chilcott, 590 F.Supp. 204, 208, 210 (D.C. Colo. 1984). The Johnson court stated:

As this more or less standard fact pattern has reappeared in the cases, receivers often have made an attenuated 'but for' causation argument to side step the failed logic of relying on misrepresentations to investors as the basis for recovering on behalf of an entity which actually benefitted from those misrepresentations.

* * *

the 'but for' causation chain fails as a matter of law to establish a proximate causal link between the misrepresentations to investors and any losses to the corporate entity.

Johnson, 590 F.Supp. at 208-09.

As one can see in the Receiver's Complaint, it is filled with the alleged misrepresentations to the investors. In his response brief, the Plaintiff alleges that there has been some misrepresentation to the corporations. [Response Brief at p.26, 31]. In the cases cited by plaintiff there exists some actual statement or failure to give information to the appropriate corporate officer about a transaction to satisfy the misrepresentation requirement. There is no such allegation plead with specificity (and no such misrepresentation exists) as required by the Federal Rules of Civil Procedure in this case. The Receiver in the Johnson case made a similar attempt to escape a dismissal of the Complaint. The court stated:

The Receiver in the instant case argues that these misrepresentations [misrepresentations to investors] are alleged in his complaint only to explain Chilcott's overall scheme, but when one looks beyond these misrepresentations and seeks to identify the specific misrepresentations made to *the fund*, it is clear that there are no such misrepresentations to identify. The misrepresentations are one and the same, running from Chilcott to the investors to induce them to invest, with the fund benefitting by each

investment.

Johnson, 590 F.Supp. at 209. See also Rochelle v. Marine Midland Grace Trust Co., 535 F.2d 523 (9th Cir. 1976); Canut v. Lyons, 450 F.Supp. 26 (C.D. Cal. 1977); Baker v. Heller, 571 F.Supp. 419 (S.D. Fla. 1983).

Plaintiff apparently is taking the position that it can rely on a fictional misrepresentation since the corporations are fictional entities. The Plaintiff's reversal of position from Complaint to response brief has also left the Plaintiff naked of the factual allegations necessary to support his new changed theory. In the Complaint, the Plaintiff has attempted to plead some type of actual or apparent authority on behalf of FSC Securities Corporation by alleging that because Payne and Danker were authorized to attempt to sell securities to investors, the actions of Payne and Danker in selling securities were within their apparent authority. However, the Plaintiff has now switched his position, with the operable acts of Payne and Danker being their acts of taking money from Heartland and JMS as Heartland and JMS officers and employees. There is no allegation in the Complaint that FSC Securities Corporation or any of the other broker dealers involved in this case had any relationship to Heartland and JMS. It would be impossible for the Complaint to allege some type of liability on the part of the broker dealer for what the owners, officers and management of a corporation did to their own corporation.

B. THE KNOWLEDGE AND ACTIONS OF KENNETH PAYNE AND GARY DANKER ARE IMPUTED TO THE CORPORATIONS FOR WHICH THEY WERE OFFICERS AND EMPLOYEES.

As an initial point, the court should not even entertain the Plaintiff's argument that the fraud of Payne and Danker cannot be visited upon Heartland and JMS. Plaintiff's Complaint has already made the allegation that Heartland and JMS defrauded, stole, misappropriated money and

committed federal securities crimes. There is no need to engage in an imputation analysis because the ultimate result of imputation (liability for crimes and misdeeds) is already given to the court by the Complaint itself. Plaintiffs principal and agency theories do not affect the standing analysis on the 12(B)(6) analysis of the securities claims. (SEC Complaint incorporated by reference, ¶ 1, 4, 5, 72, 73, 74, 76-77, 80-81, 86-87, 92-93). Assuming that this analysis is necessary, the hypocritical fallacy of Plaintiff's argument is no better illustrated than by realizing that he attempts to impute the actions and knowledge of Kenneth Payne and Gary Danker to FSC Securities Corporation which never engaged or participated in any of the fraudulent activity, while at the same time attempting to persuade the court that Payne and Danker's knowledge and activities cannot be imputed to Heartland. According to the allegations of the complaint Heartland and JMS knowingly participated in the fraud. It was the Plaintiff who was in control of the drafting of the Complaint, and it was the Plaintiff who included the allegations that Heartland and JMS, as corporate entities, knowingly engaged in the fraudulent conduct and were guilty of federal securities crimes. Although Plaintiff is now running from the result of this pleading, the Plaintiff is bound by it.

III. THE SCHOLLES V. LEHMAN DECISION IS NOT CONTROLLING AND IS AN INACCURATE STATEMENT OF THE LAW

Plaintiff's argument is also contrary to Indiana statute. Essentially, Plaintiff is arguing that Payne and Danker somehow were not allowed to take Heartland or JMS funds so the corporation is not bound by their actions in doing. Indiana looks with great disfavor on corporations performing acts and then later denying liability or responsibility for those same acts. Indiana has codified this position at I.C. 23-1-22-5.

This statute specifically gives a receiver the power to challenge corporate action but only against corporate insiders. This is consistent with Indiana's policies on tolling the statute of limitations only against active concealers and imputing acts of top management to corporations. Essentially, all of the Plaintiff's arguments, rely upon the case of Scholes v. Lehman, 56 F.3d 750 (7th Cir. 1995). Scholes is clearly not controlling because it is a purported application of Illinois law in a different factual situation when the court is presented today with a question of Indiana law. However, the action holding of Scholes, that a receiver has the ability to bring a cause of action to reverse a fraudulent transfer, is consistent with Indiana law. The law in Indiana as well as in most other jurisdiction has always held that although a person or a corporation typically could not sue to undue their own fraudulent conveyance of assets, the receiver is allowed to do this in order to bring an actual and identifiable asset back into the receiver's possession. This right is specifically provided by statutes allowing creditors to ask for a receiver to undo fraudulent transfers and another statute allowing receivers to sue to undo fraudulent transfers. I.C. 32-2-7-17 (Indiana Uniform Fraudulent Transfer Act); I.C. 34-48-1-1(1)(FSC's Brief in Support of Motion to Dismiss, p. 5-6).

Receivers have typically been allowed to recover funds or property that have been improperly transferred out of the entity in receivership as an adjunct to the receiver's responsibility to not favor one creditor over another and to marshal the assets of the estate. Receivers have actual or constructive possession of property but not ownership. Matters of Willow of Conventry, Ltd. Ptp., 154 B.R. 959 (Bry. N.D. Ind. 1993); At best, a receiver's ability to represent creditors in fraudulent conveyance springs from his right to constructive possession of the estate. Ownership remains in the original title holder. Absent a receiver, a creditor of the

corporation could obtain a judgment and then try to pursue fraudulent transfers to satisfy the judgment. Where there are a multitude of potential judgment creditors, this creates a mad dash for limited funds. Thus, a receiver is appointed and those creditors are forced to bring their claims against the receiver. Because part of marshaling the assets is to ensure a creditor first obtaining judgment is not favored over later creditors, the receiver is allowed to bring the fraudulent conveyance back into the estate so that it is divided equally. However, in the present case, this Receiver is not attempting to have property that had been transferred to FSC brought back into the estate, thus the exception does not apply.

The Scholes court then goes on to cite McCandless v. Furlaud, 296 U.S. 140, 160, 56 S.Ct. 41, 47, 80 L.Ed. 121 (1935) and Alvers v. Continental Illinois Bank & Trust Co., 296 Ill. App. 596, 17 N.E.2d 67 (1938) to support the proposition that the in pari delicto defense is eliminated when the person who is in charge of the corporation is eliminated. Neither of these authorities support this proposition. Alvers provides that Illinois has a special rule for banks in receivership that does not exist in Indiana. The United States Supreme Court itself has clarified that McCandless does not stand for the proposition that the appointment of a receiver means that the receiver can bring some cause of action that the corporation could not have brought:

Petitioner relies on McCandless v. Furlaud to support the proposition that a receiver in equity may sue third parties on behalf of bond holders. But, the opinion of the Court by Mr. Justice Cardozo clearly emphasizes that the receiver in that case was suing on behalf of the corporation, not third parties; he was simply stating the same claim that the corporation could have made had it brought suit prior to entering receivership. The debtor corporation makes no such claim in this case.

Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 429, 92 S.Ct. 1678, 32 L.Ed.2d 195

(1972) see also In Re Gaudette, 241 BR 491 (BKRD. NH. 1999). If no receiver had been appointed, Heartland and JMS could not have brought these claims.

Caplin is the leading Supreme Court decision on the abilities of trustees and receivers to bring these types of causes of action. To follow the reasoning of Caplin is to reject the Plaintiff's claim in this case. The Scholes case seems to assert that the receiver is somehow an innocent purchaser or bystander and therefore brings some type of cleansing to the corporation much like a purchaser in good faith. This is not Indiana law. In Irwin's Bank v. Fletcher Savings & Trust Co., 145 N.E. 869 (Ind. 1924), the Indiana Supreme Court clearly stated that the court should not apply equities to a receiver as if it were some type of innocent purchaser or purchaser for value in any sense. Id. at 879 quoting Fletcher American National Bank v. McDermid, 128 N.E. 685, 688 (Ind. App. 1920). In Schopert v. Indiana National Bank, 41 Ind. App. 474, 83 N.E. 515 (1908), the court stated:

It is also a rule of law that receivers take property which comes into their hands for administration subject to all legal and equitable claims.

Id. at 517

The court should also refer to the United States Supreme Court case of Deitrick v. Standard Surety Co., 303 U.S. 471 (1938). Specifically, the Court stated:

All defenses open against the bank in such case are open against the Receiver and he is chargeable with knowledge of all facts known to the bank effecting the character of the claim. If, therefore, the contract with the Surety Company was illegal as to the bank because, as the master and auditor found, the bank was charged with the knowledge of its president, a recovery based on the contract of Surety, cannot be had by the Receiver, since the recovery must be based on the pleadings, and the allegations of liability and the plaintiff's declarations are based solely on the contract of Surety.

Again, the Court held that the receiver has no greater standing to pursue claims than the original corporation had. Plaintiff cites to language from Indiana receivership cases in an attempt to support its claim that this present action would not be a vast departure from Indiana law. (Response Brief, p. 15) All of those cases support FSC's position that the receiver has no standing. In fact, the Marion Trust Co. v. Blish, 170 Ind. 686, 84 N.E. 814 (1908) case completely undermines Plaintiff's position. In Blish, the receiver brought suit against a subscriber for company stock that had not fully paid. The subscriber plead the equitable defense of fraudulent inducement. The trial court dismissed on that ground. This ruling was upheld on appeal and the receiver's status as representing creditors was discussed. The receiver argued that he represented the creditors and therefore, was not subject to the defense of fraudulent inducement. The court discussed, at length, the argument that a receiver can simply aver that he is representing creditors and therefore, bring any action and not be subject to defenses against the corporation. The court rejected this position.

In the Scholes case, the receiver was suing to undue a fraudulent conveyance of the corporation and the holding was entirely consistent with Indiana law. Some dicta in the opinion, is not only entirely inconsistent with Indiana law, but is also inconsistent with the Illinois law that it was interpreting and the common law of most other jurisdictions regarding receiverships. Because of the dicta of the Scholes decision and a similar case of the Ninth Circuit, dicta is beginning to crop up in cases across the country. It is important for this court to examine the Scholes decision and how other courts are misapplying that holding and to correct the missimpression that the dicta from the Scholes case is spreading. It is typically not spreading by

courts analyzing and adopting the reasoning, but its quotes are being repeated in trustee in bankruptcy cases and then distinguished. What typically happens is the bankruptcy court or the court of appeals in a bankruptcy case notes that the trustee in bankruptcy has attempted to support its position that it has the right to bring claims that it did not in the past by using the Scholes decision. The court quotes the Scholes decision but then states that clearly a trustee in bankruptcy has no causes of action that the debtor did not have and therefore simply states that receivership law must be different. This occurred in the case of The Official Committee of Unsecured Creditors v. RF Lafferty & Co., Inc., 267 F.3d 340 (3rd Cir. 2001). In the Lafferty opinion there were two lease financing corporations that were operated as ponzi schemes in which a principal in those organizations, aided by others, caused the corporations to issue fraudulent debt certificates which were then sold to investors. When the scheme fell through, the corporations filed for bankruptcy. Claims were brought on behalf of the two debtor corporations against third parties that had allegedly conspired with the debtor's management, who were also the debtor's sole shareholders, in perpetrating the ponzi scheme. The district court held that the committee lacked standing to assert the claims against the third parties. The court of appeals found that the debtor corporations were in pari delicto with the third party and thus held that the claims were properly dismissed. The trustee in bankruptcy made similar arguments that are being made by the receiver here. In the Lafferty case, the claim was actually brought against people who were involved in the scheme on a theory of "deepening insolvency" which would not exist against the Defendants in this action which had no legal relationship to the corporations and were not directly involved in any of the underlying transactions. The Lafferty court considered the Scholes decision and also the case of FDIC v. O'Melveny & Myer, 61 F.3d 17, 19 (9th Cir.

1995). In distinguishing these cases, the court stated:

These cases are easily distinguishable, however; unlike bankruptcy trustees, receivers are not subject to the limits of § 541.

Lafferty, 267 F.3d at 358

However, there is no distinction between bankruptcy trustees and receivers pursuant to Bankruptcy Code § 541. The reason the court found § 541 important in determining whether the in pari delicto defense was applicable was because:

under § 541, the bankruptcy estate includes ‘all legal or equitable interests of the debtor in property *as of the commencement*’ of bankruptcy.

Lafferty, 267 F.3d at 356 quoting 11 U.S.C. § 541(a)(emphasis in original quote).

Thus, all rights and defenses are fixed as of the commencement and the existence of the trustee does not enlarge those rights. Like a receiver, a trustee is given the special power, that the debtor corporation would not hold, to reverse fraudulent transfers. 11 U.S.C. § 544(b); Hayes v. Palm Seedling, Inc., 916 F.2d 528, 534-40 (9th Cir. 1990). The court went on to state that standard trustee and bankruptcy law states that a trustee in bankruptcy is subject to the same defenses that could have been asserted against the defendant and that he, “stands in the shoes of the debtor and can only assert those causes of action possessed by the debtor.” Quoting Hays & Co. v. Merrill Lynch Pierce Fenner & Smith, Inc., 885 F.2d 1149, 1154 (3rd Cir. 1989) (quoting Collier on bankruptcy, ¶ 323.02[4]). There is no difference between the way a receiver takes property and the way a trustee in bankruptcy takes property. Indiana’s law is just as clear that a receiver takes its property subject to all legal and equitable interest that exist in the corporation in receivership

